January 2021

Focus on Forecasting & the COVID-19 Pandemic

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As one would imagine, the owners of shares in any company - including companies that are partially or completely owned by an Employee Stock Ownership Plan ("ESOP") - are typically very interested in the performance of the business and its ability to create future value. This interest has been heightened as a result of the COVID-19 pandemic and its disruption to the economy, supply chains, global population and businesses throughout the world.

Although some business owners may feel the process of preparing a forecast of future performance is akin to reading a crystal ball, forecasting remains an important part of business planning since investors, including ESOP trustees, typically look to projected cash flows to determine the company's current value.

Whether or not the company has a history of forecasting, now is still a good time to start. When initially preparing a forecast, the company's management team should start with the basics. For example, depending on the type of business, management may want to review factors such as the organization's weekly, monthly or annual sales goals; whether regional sales goals are being met; if the sales team has minimum goals which need to be achieved in order for commission to be awarded; whether customer agreements require maintaining minimum inventory levels; the impact of supplier contracts - or the lack thereof - on the business; and whether there are industry benchmarks the company is trying to achieve.

Other planning tools include "top-down" and "bottom-up" forecasting. Generally speaking, top-down forecasts tend to be broad-based or "big picture" reviews. They start with general information about the overall market in which the company operates and then work down to determine the company's potential revenue based on market share. Conversely, "bottom-up" forecasting focuses on specifics within an organization and tends to have a sales- or production-based focus. In a "bottom-up" forecast, individual departments create their own outlooks which are then built into an overall company forecast. Oftentimes, companies use a hybrid of these approaches when planning, as the two methods can serve as a system of checks and balances in order to help determine whether the company's forecast is realistic and achievable based not only on the marketplace but also on feedback from key staff members such as sales leaders and/or the production team at a manufacturing firm.

Notably, when preparing a forecast that will be used as part of a valuation for ESOP purposes, it is also important to consider the U.S. Department of Labor's ("DOL") perspective. Projections, the validity of the projection assumptions and their impact on a company's valuation have been a central focus of the DOL's enforcement efforts. Although these reviews by the DOL were conducted before the COVID-19 pandemic, it seems likely similar questions will continue to be asked.

Pitfalls to Avoid When Forecasting

In our view, the DOL considers it important for both the valuation firm and the ESOP trustee to conduct a critical analysis of the management team's projections before incorporating them into the fair market value analysis. Key issues the DOL has suggested should be analyzed relate to the consistency of performance comparison, achievability of the forecast and the overall sensitivity of assumptions. While these are good questions to ask any time a forecast is being prepared - whether for an internal corporate purpose, planning for an acquisition or in the context of an ESOP - the DOL has looked to the rigor with which this analysis is being conducted by the valuation firm and the ESOP trustee as well as the documentation that is available to support the forecast.

In addition, shareholders, as well as valuation firms and ESOP trustees, should look to see whether the management team's forecast has addressed the unique challenges of the current environment. When a company experiences a sharp decline in revenue, such as during the pandemic, the forecast should make rational assumptions about how the company will work through the recovery. Since the pandemic is still ongoing as of this writing, the path to recovery remains somewhat unclear. Management teams must do their best to consider a wide range of factors when preparing forecasts in the current environment. The forecast should project out to a time period which the management team anticipates will be a period of "normal" growth or when margins will stabilize at a targeted level. In the scenario of the current pandemic, depending on the specific company under review, this may be three to five years away, or more.

In any case, there are several issues to consider when preparing a forecast for recovery from the COVID-19 pandemic, including the following:

- *Implied Growth Rates* - During recovery from the global pandemic and associated recession, the company may experience some "growth"

- Using financial performance estimates that are inconsistent with the actual financial performance of the company
- Aggressive and unsupportable growth projections
- Competitive position not supportable
- Failure to account for declining performance within company and broader economy
- Failure to consider customer concentration or cyclical trends
- Unduly optimistic operating margin projections, out of line with projections within the most analogous industry

rates that are not the "normal" level. In reality, the company may not be growing to a new level; rather, it may be recovering from declines. Therefore, what comes after 2020 in the forecast may not be indicative of past performance or even industry performance. Although it may be a challenge in terms of year-over-year performance comparison, when preparing a one- to five-year forecast, think about whether the company will return to "regular" growth, recover back to pre-pandemic levels or transition to a "new normal." While this starts with analyzing topline revenue, consider the impact on trends in earnings and cash flow as you work through the forecasting process.

- *Customers and Suppliers* - It may be helpful to look at the impact of individual customers or suppliers to your forecast. For example, is all or a portion of the customer base expected to change in light of changes related to COVID-19? Or, if your company has lost a key customer account, what impact will that have on the forecast? In addition, will the change in customer base or the loss of a key customer impact just one division or segment of your business, will it have an outsized impact on a part of the business or will it impact the business as a whole? This analysis can be carried out for customers and suppliers, highlighting areas of risk and opportunity within the business.
- *Fixed and Variable Costs* - The impact of fixed and variable costs will also have a significant effect on the forecast through the pandemic and recovery. Fixed costs are those that remain the same regardless of production volume or output. Fixed costs may include facility-related costs, insurance expense and salaries paid to employees. Meanwhile, variable costs may change based on the amount of output; this may include items such as commissions and the cost of raw materials. For many businesses, labor costs are the largest cost of doing business. Therefore, if the size of the workforce changes significantly, there may be a meaningful impact on costs. Additionally, if offices are closed and facilities are operating at reduced capacity, the cost is generally the same fixed cost, which lowers margins significantly. During the recovery, however, the company may experience significant margin expansion as revenue returns to help cover the cost. This will impact costs, potentially throughout the entirety of the forecast, depending on what the burden rate looks like not just in year one, but in years two, three, four and five of the forecast.
- *Compensation* - Another area on which to focus is compensation, which is impacted by workforce continuity. In that regard, the aim of the Small Business Administration's Paycheck Protection Program and other COVID-19 relief programs was to keep the labor force together; as a result, the company may have a labor force, or burden rate, that does not correlate with the level of sales or production that the company is experiencing. Therefore, it may be helpful to think about the company's cost profile and how it will work out in future years. Additionally, if the business has implemented any pay reductions - for example, some executive teams took salary cuts in 2020 - it is relevant to think about when salaries will be reinstated, in full or in part, and how that will impact margins.
- *Capital Expenditures* - With regard to capital expenditures - which is when an organization spends money or takes on debt to acquire, upgrade or maintain physical assets such as property, plants, technology or equipment - some companies may choose to defer investments in the next year or two, or more, in order to preserve cash. Conversely, if a company has not been significantly impacted by the recession, it may decide to invest in an effort to prepare and potentially gain an advantage from the recovery. These types of plans should be reflected in the forecast.
- *Working Capital* - Working capital is the difference between a company's current assets (i.e. cash, accounts receivable and inventories) and its current liabilities (i.e. accounts payable). As part of the forecast, it is important to

thoroughly analyze what some of the company's bigger balance sheet items - such as accounts receivable ("AR") and inventory turnover - will be and if they will be impacted by the recovery. For instance, on the inventory side, is the company subject to any minimum purchase agreements? Or, is the company taking in or holding a level of inventory that is not reflective of expected sales? In that regard, many companies have experienced supply chain disruption during the pandemic; as a result, they are holding more inventory than normal simply so they do not run into shortages in key components and materials. Therefore, on their forecast, the first-year assumption of inventory turnover may imply lower turnover since the company is holding higher inventory. Going forward, once the supply chain disruption has passed, the company may move back to a more normal targeted level of inventory. Meanwhile, another key consideration is AR. Often, during distress, customers take advantage of paying on longer terms. As a result, normal assumptions for AR days will not be sufficient, which may result in less working capital being freed up during a portion of the forecast period; this is important, as it impacts cash flow planning and is a key valuation assumption.

- *Historical Context* - If the company was in existence during the Great Recession and the recovery, it can be helpful for the management team to look back at how the company performed, how long it took to recover and what the company's projections were at the time. While the global pandemic is impacting industries and geographies very differently than the Great Recession did, it can nevertheless be a good exercise to go back and analyze and understand the forecasting that was done at the time versus the actual recovery. When reviewing the prior forecast, keep in mind that recovery rates of growth tend to be significantly greater than historical annual growth rates.

- *Other Data Sources* - It is also helpful to review trade publications, industry studies and economic studies, as they can be a great source of information to help with a forecast. It is important to ensure that each data source is reliable so that it can be used as a way to substantiate the forecast. However, do be aware and cognizant of confirmation bias when considering other data sources. Confirmation bias is the tendency to search for, interpret or favor information in a way that confirms or supports the projection assumptions. Be careful to weight data sources based on their source, relevancy and timeliness.

While this outline includes numerous factors to consider when preparing a pandemic and post-pandemic forecast, the specific factors which should be included in a forecast for your company may vary depending on the specific market and industry in which that company participates. Remember, any forecast includes inherent risk, and this is especially true in the uncertain times in which we are operating. In any case, it is important to keep in mind that all investors are interested in future performance, and therefore, when preparing a post-pandemic forecast, the management team should be cognizant of any new information which may impact the company's outlook.

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